WR-FC--95-03

SOUTHWESTERN FEDERAL POWER SYSTEM

**Combined Financial Statements
and Supplemental Schedules**

(With Independent Auditors' Reports Thereon)

For the Years Ended September 30, 1994 and 1993

MASTER

DISTRIBUTION OF THIS DOCUMENT IS UNLIMITED

for-

DISCLAIMER

This report was prepared as an account of work sponsored by an agency of the United States Government. Neither the United States Government nor any agency thereof, nor any of their employees, make any warranty, express or implied, or assumes any legal liability or responsibility for the accuracy, completeness, or usefulness of any information, apparatus, product, or process disclosed, or represents that its use would not infringe privately owned rights. Reference herein to any specific commercial product, process, or service by trade name, trademark, manufacturer, or otherwise does not necessarily constitute or imply its endorsement, recommendation, or favoring by the United States Government or any agency thereof. The views and opinions of authors expressed herein do not necessarily state or reflect those of the United States Government or any agency thereof.

DISCLAIMER

Portions of this document may be illegible in electronic image products. Images are produced from the best available original document.

SOUTHWESTERN FEDERAL POWER SYSTEM

TABLE OF CONTENTS

	<u>Page Number</u>
Overview	1
Performance Measurements.....	3
Independent Auditors' Report	6
Financial Statements:	
Combined Statements of Assets, Federal Investment, and Liabilities - September 30, 1994 and 1993	8
Combined Statements of Revenues, Expenses, and Accumulated Net Revenues- Years ended September 30, 1994 and 1993	9
Combined Statements of Cash Flows - Years ended September 30, 1994 and 1993	10
Notes to Combined Financial Statements	11
Supplemental Schedules:	
Combining Statements of Assets, Federal Investment, and Liabilities - September 30, 1994 and 1993	17
Combining Statements of Revenues, Expenses, and Accumulated Net Revenues - Years ended September 30, 1994 and 1993	19
Combining Statements of Cash Flows - Years ended September 30, 1994 and 1993	21
Independent Auditors' Report on Internal Control Structure	23
Independent Auditors' Report on Compliance with Laws and Regulations.....	28

SOUTHWESTERN FEDERAL POWER SYSTEM

OVERVIEW

The Southwestern Federal Power System

The Southwestern Federal Power System encompasses the operation of 24 hydroelectric power plants by the U.S. Army Corps of Engineers and the marketing of power and energy from those plants by Southwestern Power Administration of the U.S. Department of Energy.

To integrate the operation of these hydroelectric generating plants and to transmit power from the dams to its customers, Southwestern Power Administration (Southwestern) maintains 2,220 kilometers (1,380 miles) of high-voltage transmission lines, 24 substations, and 46 microwave and VHF radio sites. Southwestern's headquarters are in Tulsa, Oklahoma; its dispatch center is in Springfield, Missouri; and its maintenance crews are based in Jonesboro, Arkansas, in Gore and Tupelo, Oklahoma, and in Springfield, Missouri. Three divisions - Administration and Rates, Power Marketing and Delivery, and Maintenance - are responsible for meeting Southwestern's mission.

Twelve of the 24 generating plants are scheduled directly by Southwestern, and a total of 19 contribute to the interconnected system operations. Generation at the five remaining projects (Denison, Narrows, Sam Rayburn, Whitney, and Willis) is used to serve specific customer loads.

At the end of fiscal year 1994, Southwestern marketed power and energy to 10 generation and transmission cooperatives, one distribution cooperative, three military installations, 41 municipal utilities, and three municipal utility joint-action agencies. One of the joint-action agencies has its own allocation of power from Southwestern; the other two serve 34 municipal utilities to whom Southwestern has allocated power. The total number of power allocation customers is 92. Additionally, excess energy is occasionally sold to non-allocation utilities.

Mission Statement

The primary purposes of Southwestern are to market Federally generated hydroelectric power, operate a reliable and safe transmission system, and encourage energy efficiency for the benefit of the region. All of this is accomplished by professional, courteous, customer-oriented people.

Section 5, Flood Control Act of 1944

Section 5 of the Flood Control Act of 1944 as set out in Title 16 U.S.C.A. Section 825 sets forth the mission of Southwestern Power Administration, which was established in 1943.

Electric power and energy generated at reservoir projects under the control of the Department of the Army and in the opinion of the Secretary of the Army not required in the operation of such projects shall be delivered to the Secretary of Energy. The Secretary shall transmit and dispose of such power and energy in such manner as to encourage the most widespread use thereof at the lowest possible rates to consumers consistent with sound business principles, the rate schedules to become effective upon confirmation and approval by the Secretary of Energy. Rate schedules shall be drawn having regard to the recovery (upon the basis of the application of such rate schedules to the capacity of the electric facilities of the projects) of the cost of producing and transmitting such electric energy, including the amortization of the capital investment allocated to power over a reasonable period of years. Preference in the sale of such power and energy shall be given to public bodies and cooperatives. The Secretary of Energy is authorized, from funds to be appropriated by the Congress, to construct or acquire, by purchase or other agreement, only such transmission lines and related facilities as may be necessary in order to make the power and energy generated at said projects available in wholesale quantities for sale on fair and reasonable terms and conditions to facilities owned by the Federal Government, public bodies, cooperatives, and privately owned companies. All the monies received from such sales shall be deposited in the Treasury of the United States as miscellaneous receipts.

Financial Statement Presentation

1. The combined financial statements have been prepared to report the financial position and results of operations of the Southwestern Federal Power System pursuant to the requirements of the Chief Financial Officers Act of 1990.
2. While the statements have been prepared from the books and records of the Southwestern Power Administration and the related U.S. Army Corps of Engineers in accordance with the formats prescribed by the Office of Management and Budget, the statements are different from the financial reports used to monitor and control budgetary resources which are prepared from the same books and records.
3. The combined financial statements should be read with the realization that they are for a component of a sovereign entity, that liabilities not covered by budgetary resources cannot be liquidated without the enactment of an appropriation, and that the payment of all liabilities other than for contracts can be abrogated by the sovereign entity.

Performance Measurements

Performance measurements which are used to determine effectiveness and efficiency of programs in the areas of financial performance and program performance are:

- Debt service coverage ratio
- Cumulative principal payments as a percent of total Federal investment
- Percent variance of actual from planned annual principal payments
- Net cash flow to the Treasury
- Lost work day case rate
- Total recordable case rate
- Motor vehicle accident rate
- Transmission system performance index
- Total pounds of polychlorinated biphenyl (PCB) disposed

National Performance Review

Southwestern is developing plans in response to the National Performance Review mandate which directs specific areas of reform within the Government. Those reforms target reducing the Federal budget and increasing revenues by:

- decreasing Federal employment,
- increasing employee-to-supervisor ratios,
- reducing service contracts by 20 percent,
- decreasing the number of directives and regulations by half, and
- increasing receipts from the Power Marketing Administrations.

Government agencies have been allowed three to five years to comply with the individual mandates.

Standard Financial Management System

Southwestern is working with Alaska, Southeastern and Western Area Power Administrations to jointly establish a standard financial management system. The system is scheduled to be implemented at each organization in late 1995 or early 1996. More current computing hardware and software technology will result in substantially reduced maintenance costs with the standard system. Software support costs will be reduced with only a single system to maintain. The standard system will also provide consistent reporting capabilities for all of the organizations for external reporting.

PERFORMANCE MEASUREMENTS

Southwestern Power Administration, in conjunction with the Department of Energy and the other four Power Marketing Administrations, developed a list of common and program-specific performance measurements as required in the Chief Financial Officers (CFO) Act of 1990 to help monitor specific areas of interest.

Southwestern's nine performance measurements are grouped into two categories: Financial Performance Measures and Program Performance Measures. The Program Performance Measures consist of Transmission System Performance Measures and Environmental Performance Measures.

Financial Performance Measures

Southwestern has developed four financial performance measures for the past eight years. These measures, used as management tools, include the Debt Service Coverage Ratio, Cumulative Principal Payments as a Percent of Total Federal Investment, Percent Variance of Actual from Planned Annual Principal Payments, and Net Cash Flow to the Treasury. The past five years' summarization of these measures is as follows:

	Fiscal Year				
	1990	1991	1992	1993	1994
1. Debt service coverage ratio	1.495	1.124	1.142	1.490	1.265
2. Cumulative principal payments as a percent of total Federal investment	21.14%	22.84%	25.36%	29.86%	32.74%
3. Percent variance of actual from planned annual principal payments	69.74%	(8.90%)	13.08%	66.16%	35.98%
4. Net cash flow to the Treasury (000's)	\$25,627	\$17,504	\$32,324	\$38,162	\$25,579

1. Debt service coverage ratio

Southwestern shares a statutory and administrative requirement to establish rates that repay the U.S. Treasury for the Federal investment of its hydroelectric power systems. Rates are designed under average water conditions to provide for a 1.0 or higher debt service coverage ratio. Generally, this ratio is recognized as a direct measure of the sufficiency of cash flows to cover planned payments of both principal and interest to the U.S. Treasury.

Five-year Analysis: Southwestern's debt service coverage ratio for the past five years has exceeded the 1.0 target, indicating that annual revenues were sufficient to service the agency's planned payments.

2. Cumulative principal payments as a percent of total Federal investment

This measure provides information showing the relationship between the cumulative amount of principal Southwestern has repaid to date and the total Federal investment to be repaid. While analysis of this indicator does not necessarily provide conclusive information without further analysis of additional factors such as the average of the system, relative interest rates, and other contractual commitments, the measure nevertheless provides information on the status of repayment.

Five-year Analysis: The measure illustrates that Southwestern has made continual progress toward the repayment of its total investment.

3. Percent variance of actual from planned and annual principal payments

This measure provides direct information as to the agency's ability to meet its planned payments to the U.S. Treasury in any given year. As with other indicators that are influenced by current period revenues, a substantial variability will result in the amount of annual revenues being applied due to the variability caused primarily by water conditions of hydro-based systems.

Five-year Analysis: The variances cited above show that the agency's ability to match its planned principal payments is directly and significantly impacted by water conditions.

4. Net cash flow to the Treasury

This provides a measure of, among other things, the actual net cash flows (inflows less outflows) to the U.S. Treasury for a fiscal year. It provides a measure of either a cash sufficiency or deficiency. Variations in annual expenses and water conditions have a diluting impact on the efficiency of the measurement. Therefore, this measure should be used in conjunction with the other financial measures listed above to evaluate financial performances.

Five-year Analysis: In each of the past five years, Southwestern has been able to provide for the U.S. Treasury a positive net cash flow.

Program Performance Measures

Southwestern Power Administration's Program Performance Measures of Transmission System and Environmental Program Performance Measures were developed for the first time in fiscal year 1992. Therefore, the only established baseline to historically evaluate these performance measures is a three-year comparison. However, Southwestern plans to establish benchmarks for each program category for maximum effectiveness in evaluating performance.

Transmission System Performance

Occupational Health and Safety Measures:

5. *Lost work day case rate*

This rate represents a ratio of the number of days away from work compared to total man-hours worked per year. This measure was established by the Bureau of Labor Statistics. Southwestern's rate for 1994 was 2.59 cases per 100 employees compared to 2.24 and 2.60 cases in 1993 and 1992, respectively.

6. *Total recordable case rate*

This rate represents a ratio of the number of all work-related injuries which result in loss of consciousness, restrictions of work or motion, transfer to another job, or medical treatment beyond first aid compared to the total man hours worked. This measure was established by the Bureau of Labor Statistics. Southwestern's rate in 1994 was 4.14 cases per 100 employees compared to 7.27 and 3.12 cases in 1993 and 1992, respectively.

7. *Motor vehicle accident rate*

This rate represents a ratio of all work-related motor vehicle accidents compared to the total vehicle miles driven. Southwestern's rate in 1994 was 3.67 accidents per one million miles driven compared to 4.93 and zero in 1993 and 1992, respectively.

8. *Transmission system performance index*

Transmission system reliability is a fundamental requirement of every electrical utility operation to provide the desired electrical services. Determination of reliability is complex. Southwestern is monitoring criteria established by the North America Electric Reliability Council in an effort to measure this complex issue. The criteria in 1994 was identified as matching generation with its load obligation. In 1994, Southwestern had a 96.5 performance index, identical to 96.5 percent reported in both 1993 and 1992.

Environmental Performance

9. *Total pounds of Polychlorinated Biphenyl (PCB) disposed*

While maintaining a competitive ability to serve Southwestern's customers, the mission must be completed in an environmentally safe manner. Disposal of any contaminated substances will be completed in a prompt and efficient manner. Southwestern will track this environmentally related information for compliance goals. Disposal of PCB-contaminated substances by Southwestern at a disposal facility approved by the Environmental Protection Agency amounted to 3,744 kilograms (8,246 pounds) in 1994 compared to 950 kilograms (2,093 pounds) and 425 kilograms (935 pounds) in 1993 and 1992, respectively.

700 Oklahoma Tower
Oklahoma City, OK 73102-5671

1600 One Williams Center
Tulsa, OK 74172-0168

INDEPENDENT AUDITORS' REPORT

The Administrator of
Southwestern Power Administration
U.S. Department of Energy:

We have audited the accompanying combined statement of assets, Federal investment, and liabilities of the Southwestern Federal Power System (SWFPS) as of September 30, 1994, and the related combined statements of revenues, expenses, and accumulated net revenues, and cash flows for the year then ended. These combined financial statements are the responsibility of SWFPS' management. Our responsibility is to express an opinion on these combined financial statements based on our audit. The combined financial statements and supplementary combining information of SWFPS as of September 30, 1993, were audited by other auditors whose report dated December 17, 1993, expressed an unqualified opinion with an explanatory paragraph that described the tentative allocation of certain utility plant costs and expenses between power and non-power purposes discussed in Note 3 to the combined financial statements.

We conducted our audit in accordance with generally accepted auditing standards; *Government Auditing Standards* (1988 Revision), issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin 93-06, *Audit Requirements for Federal Financial Statements*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the combined financial statements referred to above present fairly, in all material respects, the financial position of the SWFPS as of September 30, 1994, and the results of its operations and changes in accumulated net revenues and its cash flows for the year then ended in conformity with generally accepted accounting principles.

Our audit was made for the purpose of forming an opinion on the combined financial statements taken as a whole. The combining information as of and for the year ended September 30, 1994, is presented for purposes of additional analysis of the combined financial statements rather than to present the financial position, results of operations and changes in accumulated net revenues and cash flows of the two groups of accounts as described in Note 1. The combining information has been subjected to the auditing procedures applied in the audit of the SWFPS financial statements and, in our opinion, is fairly stated in all material respects in relation to the 1994 financial statements taken as a whole.

As discussed in Note 3 to the combined financial statements, certain utility plant costs and operation and maintenance expenses relating to multi-purpose projects have been allocated on a tentative basis between power and non-power purposes. The amount of adjustments, if any, that may be necessary when the final allocations are made are not presently determinable. Accordingly, no adjustments to the related assets, revenue and expense accounts have been recognized in the accompanying combined financial statements.

As discussed in Note 6 to the combined financial statements, there is an uncertainty related to the amount of interest on Federal investment that is required to be recognized. The ultimate outcome of the matter cannot presently be determined. Accordingly, no provision for any liability that may result from the resolution has been recognized in the accompanying combined financial statements.

Our audit was made for the purpose of forming an opinion on the combined financial statements taken as a whole. The information presented in management's *Overview and Performance Measurements* is not a required part of the financial statements, but is supplementary information required by OMB Bulletin 94-01, *Form and Content of Financial Statements*. We have considered whether this information is materially inconsistent with the combined financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the combined financial statements and, accordingly, we do not express an opinion on it. The performance information included in management's *Overview and Performance Measurements* is addressed in our auditors' report on internal control structure in accordance with OMB Bulletin No. 93-06.

KPMG Peat Marwick LLP

Tulsa, Oklahoma
December 16, 1994

SOUTHWESTERN FEDERAL POWER SYSTEM
Combined Statements of Assets, Federal Investment, and Liabilities
September 30, 1994 and 1993

<u>Assets</u>	<u>1994</u>	<u>1993</u>
Utility plant:		
Plant in service	\$ 1,037,732,999	1,025,621,415
Accumulated depreciation	(262,106,439)	(250,539,198)
Construction work in progress	33,892,080	22,124,448
Retirement work in progress	94,123	104,431
Net utility plant	<u>809,612,763</u>	<u>797,311,096</u>
Current assets:		
Unexpended appropriations	45,888,368	38,975,438
Accounts receivable	10,308,906	10,439,719
Materials and supplies, at average cost	5,539,947	3,925,819
	<u>61,737,221</u>	<u>53,340,976</u>
Banking exchange	16,144,112	15,579,585
Other assets	982,814	650,817
	<u>\$ 888,476,910</u>	<u>866,882,474</u>

Federal Investment and Liabilities

Federal investment:		
Investment of U.S. Government:		
Congressional appropriations	\$ 1,924,187,761	1,844,397,199
Transfers from other federal agencies	26,723,735	26,204,747
Interest on Federal investment	619,894,268	601,461,624
Funds returned to U.S. Treasury	(1,797,143,072)	(1,697,636,459)
Net investment of U.S. Government	773,662,692	774,427,111
Accumulated net revenues	67,782,348	47,144,736
Total Federal investment	841,445,040	821,571,847
Current liabilities - accounts payable and accrued liabilities	11,121,248	9,278,886
Purchase power and banking exchange deferral	35,608,965	35,747,376
Hydropower revenue deferral	301,657	284,365
Commitments and contingencies (Notes 3 and 5)		
Total Federal investment and liabilities	<u>\$ 888,476,910</u>	<u>866,882,474</u>

The accompanying notes are an integral part of these power system combined financial statements.

SOUTHWESTERN FEDERAL POWER SYSTEM

Combined Statements of Revenues, Expenses, and Accumulated Net Revenues

Years ended September 30, 1994 and 1993

	<u>1994</u>	<u>1993</u>
Revenues:		
Sales of electric power:		
Cooperatives	\$ 66,795,409	70,873,303
Municipalities	27,054,771	25,736,676
Federal and state agencies	4,347,196	3,758,622
Investor owned utilities	1,300	49,166
Banking exchange	6,381,237	8,705,049
Transmission service charges for others	3,015,334	2,796,419
Other	306,513	286,328
Total revenues before deferrals	<u>107,901,760</u>	<u>112,205,563</u>
Net purchase power credit and banking exchange	<u>1,501,755</u>	<u>3,542,538</u>
Total revenues	<u>109,403,515</u>	<u>115,748,101</u>
Expenses:		
Operation and maintenance	47,657,576	43,331,000
Purchase power and banking exchange	7,751,565	6,474,934
Depreciation	12,634,514	10,872,345
Transmission service charges by others	2,645,019	2,690,554
Other	<u>(19,909)</u>	<u>(36,218)</u>
Total expenses excluding interest	<u>70,668,765</u>	<u>63,332,615</u>
Net revenues before interest expense	<u>38,734,750</u>	<u>52,415,486</u>
Interest expense on Federal investment	19,750,066	18,253,338
Allowance for funds used during construction	<u>(1,652,928)</u>	<u>(993,002)</u>
	<u>18,097,138</u>	<u>17,260,336</u>
Net revenues	20,637,612	35,155,150
Accumulated net revenues:		
Balance at beginning of year	<u>47,144,736</u>	<u>11,989,586</u>
Balance at end of year	\$ <u>67,782,348</u>	<u>47,144,736</u>

The accompanying notes are an integral part of these power system combined financial statements.

SOUTHWESTERN FEDERAL POWER SYSTEM

Combined Statements of Cash Flows

Years ended September 30, 1994 and 1993

	<u>1994</u>	<u>1993</u>
Cash provided by operating activities:		
Net revenues	\$ 20,637,612	35,155,150
Items not requiring cash:		
Interest expense on Federal investment	18,097,138	17,260,336
Depreciation	12,634,514	10,872,345
(Increase) decrease in:		
Accounts receivable	130,813	205,059
Materials and supplies	(1,614,128)	(13,127)
Banking exchange	(564,527)	(3,550,205)
Other assets	(331,997)	(209,442)
Increase (decrease) in:		
Accounts payable and accrued liabilities	1,842,362	763,741
Purchase power and banking exchange deferral	(138,411)	(1,811,377)
Hydropower revenue deferral	<u>17,292</u>	<u>13,143</u>
Cash provided by operating activities	<u>50,710,668</u>	<u>58,685,623</u>
Cash used in investing activities:		
Additions to utility plant	(22,764,265)	(17,352,640)
Allowance for funds used during construction	<u>(1,652,928)</u>	<u>(993,002)</u>
Cash used in investing activities	<u>(24,417,193)</u>	<u>(18,345,642)</u>
Cash provided by (used in) capital financing activities:		
Funds returned to U.S. Treasury	(99,506,613)	(101,431,850)
Congressional appropriations	79,790,562	53,718,887
Interest on Federal investment - purchase power deferral	<u>335,506</u>	<u>(751,993)</u>
Cash used in capital financing activities	<u>(19,380,545)</u>	<u>(48,464,956)</u>
Net increase (decrease) in cash	6,912,930	(8,124,975)
Cash at beginning of year	<u>38,975,438</u>	<u>47,100,413</u>
Cash at end of year	\$ <u>45,888,368</u>	<u>38,975,438</u>
Noncash investing activities and other transactions -		
Transfer of plant in service from other Federal agencies	\$ <u>518,988</u>	<u>107,408</u>

The accompanying notes are an integral part of these power system combined financial statements.

SOUTHWESTERN FEDERAL POWER SYSTEM

Notes to Combined Financial Statements

September 30, 1994 and 1993

(1) Summary of Significant Accounting Policies

General Information and Basis of Preparation of Financial Statements

The accompanying combined financial statements of the Southwestern Federal Power System include the accounts of the Southwestern Power Administration (Southwestern), a unit of the U.S. Department of Energy (DOE), and the accounts of the Southwestern hydroelectric generating plants and power operations of the U.S. Army Corps of Engineers (Corps), a unit of the Department of Defense. These two groups of accounts are collectively referred to as the "Southwestern Federal Power System" (SWFPS).

The Corps has constructed and operates hydroelectric generating plants in the states of Oklahoma, Missouri, Arkansas and Texas. Costs of multi-purpose Corps projects are allocated to power and non-power purposes. The portion of such project costs allocated to power is included in the financial statements. Southwestern, as designated by the Secretary of the DOE, purchases, transmits and markets power.

Southwestern and the Corps are separately managed and financed and each maintains its own accounting records. For purposes of financial and operational reporting, the facilities and related operations are considered one entity. SWFPS' income and facilities are exempt from taxation.

SWFPS is subject to the regulations of the Federal Energy Regulatory Commission (FERC). Accounts are maintained in accordance with generally accepted accounting principles, the uniform system of accounts prescribed for electric utilities by the FERC, the accounting practices and standards established by the DOE, and the requirements of specific legislation and executive directives issued by government agencies. SWFPS' financial statements are prepared in accordance with Statement of Financial Accounting Standards No. 71, *Accounting for the Effects of Certain Types of Regulation* (SFAS No. 71), which requires that the effects of the rate-making process be recorded. Such effects can provide reasonable assurance about the existence of an asset, reduce or eliminate the value of an asset, or impose a liability on a regulated enterprise.

Utility Plant and Depreciation

Plant in service and construction and retirement work in progress consist principally of generating and transmission facilities as follows:

	<u>1994</u>	<u>1993</u>
Generating facilities	\$ 926,360,391	916,641,572
Transmission facilities	<u>145,358,811</u>	<u>131,208,722</u>
	<u>\$ 1,071,719,202</u>	<u>1,047,850,294</u>

SOUTHWESTERN FEDERAL POWER SYSTEM
Notes to Combined Financial Statements, Continued

Plant in service and construction and retirement work in progress are stated at original cost or at appraisal value for property transferred from other government agencies. Cost includes direct labor and materials, payments to contractors, indirect charges for engineering, supervision and similar overhead items, and allowance for funds used during construction. The costs of additions and betterments are capitalized. Repairs and minor replacements are charged to operation and maintenance expense. Generally, the cost of utility plant retired, together with removal costs less salvage, is charged to accumulated depreciation when it is removed from service. Gains and losses are recognized only on sales of significant identifiable assets.

Depreciation on utility plant is computed on a straight-line basis over the estimated service lives of the various classes of property. Service lives are currently estimated to average approximately 41 years for transmission plant and 93 years for generating plant. Upon review of utility plant facilities usage, it was determined that depreciation formally charged to power production should be charged to other purposes. Accordingly, a one-time \$1,700,000 reduction of depreciation was recorded in 1993. This change will not have a material impact on future periods.

Unexpended Appropriations

Unexpended appropriations consist of the unexpended balance of funds appropriated by Congress for construction and operation and maintenance purposes and are maintained by the U.S. Treasury. For purposes of the statements of cash flows, unexpended appropriations are considered to be cash.

Congressional Appropriations

Congressional appropriations received by the Corps are authorized and allocated to individual projects on a total project basis. These total project allocations are further distributed among power and non-power purposes at the discretion of project management. Power purpose allocations may vary from actual amounts expended during the year. It is the intent of Corps project management to distribute congressional appropriations in amounts approximating estimated current year expenses and to adjust the distribution as necessary within the limits of the transfer authority residing at the district level.

Revenues

Operating revenues are recorded on the basis of service rendered. Rates are established under requirements of the Flood Control Act of 1944, related legislation and executive departmental directives, and are to provide sufficient revenues to meet all required payments for system costs, including operation and maintenance expenses less depreciation expenses including interest and payment to the U.S. Treasury for the Federal investment in utility plant. Rates are intended to provide for recovery of the Federal investment in transmission and generating facilities within the service lives of the assets, not to exceed 50 years from the date placed in service, while operation and maintenance costs and interest on Federal investment are recovered annually.

SOUTHWESTERN FEDERAL POWER SYSTEM
Notes to Combined Financial Statements, Continued

As set forth in "Utility Plant and Depreciation" above, assets are being depreciated for financial reporting purposes using the straight-line method over their estimated service lives which currently average approximately 41 years for transmission facilities and 93 years for generating facilities. Accordingly, annual depreciation charges are not matched with the recovery of the related capital costs and will, in the case of generating facilities, continue beyond the period within which such costs will have been recovered through rates.

While energy and transmission rates are established to recover the costs of operating the power projects, rates are also required to be at the lowest possible level, consistent with sound business principles. Over the life of the power system, accumulated net revenues represent differences between the timing of the recognition of expenses and related revenues, resulting primarily from the difference between the recognition of depreciation and the related recovery of the U.S. Treasury's investment in utility plant. SWFPS is a nonprofit agency, thus at any given time the accumulated net revenue (deficit) balance is deemed to represent deferred revenue or expense, respectively.

The practice followed by SWFPS is in conformity with the accounting practices and standards established by the DOE and the requirements of specific legislation and executive directives issued by government agencies.

Purchase Power and Banking Exchange Deferral and Receivable

A separate rate component (addor) recovers the cost of purchased power based upon the average purchased power costs over the past several years. If the actual expenses of purchased power exceed the revenue generated from this addor, the cost is deferred for future recovery through rates. Likewise, if the expense is less than the addor, the excess revenue is deferred. In 1988, SWFPS determined that the deferred revenue accumulated from the addor exceeded estimated requirements. As a result, refunds of the addor have been accomplished by including a purchase power credit in the rate schedules approved for the period July 1, 1988 through September 30, 1994. SWFPS calculates interest on the purchased power deferral at the applicable current interest rate established in the fiscal year of the deferral. Such interest is deferred to offset future purchase power costs.

SWFPS has arrangements with certain customers in which excess power generated by SWFPS is banked with the customer until needed by SWFPS and the customer has excess power available. SWFPS records a receivable for the power banked at the customers' cost of generation. The net revenue or expense associated with banking activity is deferred.

Interest on Federal Investment

Interest on Federal investment is a cost mandated by the Secretaries of the Departments of Energy and Defense and the FERC. Southwestern computes interest in accordance with DOE Order RA 6120.2 which provides that interest be computed on the remaining investment after revenues have been applied to recovery of costs during the year, any prior year unpaid costs, and then to Federal investment, bearing the highest interest rate first (see Note 4).

SOUTHWESTERN FEDERAL POWER SYSTEM
Notes to Combined Financial Statements, Continued

Allowance for Funds Used During Construction (AFUDC)

The FERC Uniform System of Accounts defines AFUDC as the net costs for the period of construction of borrowed funds used for construction purposes and a reasonable rate on other funds when so used. While cash is not realized currently from this allowance, it is realized under the rate making process over the repayment life of the related property through increased revenues resulting from higher recoverable investment. The interest rates used are established by law, administrative order or administrative policy for the fiscal year during which the construction commenced (Fiscal Year 1994 7.125 percent).

Retirement Benefits

All employees engaged in SWFPS activities participate in either the Civil Service Retirement System (CSRS) or the Federal Employees' Retirement System (FERS). Both are contributory defined benefit pension plans. Retirement benefit expense under CSRS is equivalent to seven percent of eligible employee compensation and under FERS is variable based upon options chosen by the participants but does not exceed 24.2 percent of eligible employee compensation. Actuarial data regarding funding is not available. Retirement benefits are payable by the U.S. Government and not by SWFPS. In addition, certain health care benefits are provided for substantially all retired employees. The cost of providing these benefits is an expense of the U.S. Government and not SWFPS.

(2) Confirmation and Approval of New Rates

Integrated system rate schedules were confirmed and approved by the FERC on a final basis on September 18, 1991. These rates were placed into effect on a two-step incrementally increasing basis for the period October 1, 1990 through September 30, 1994. The final increase of 5.7 percent became effective April 1, 1992. On August 29, 1994, the rates were extended through September 30, 1995, by the Deputy Secretary of Energy. The Sam Rayburn and Robert Douglas Willis projects are presently under rates which were confirmed and approved by FERC on a final basis on August 11, 1993, and are in effect from October 1, 1993 through September 30, 1997. The Sam Rayburn project experienced a 14.7 percent increase in rates while the Robert Douglas Willis project experienced a 30.4 percent decrease in rates.

(3) Tentative Cost Allocations

Allocations of plant cost and operation and maintenance expense between power and non-power purposes for four of the Corps' operating projects are presently based on tentative allocations. At September 30, 1994, total plant costs for these four projects were \$1,176,020,691, of which \$310,813,886 was tentatively allocated to power and subject to adjustment. The amount of adjustments that may be necessary when final allocations are approved for these projects is not presently determinable. When final allocations are made, the cumulative effect will be determined and reflected as an adjustment to the financial statements at that time.

SOUTHWESTERN FEDERAL POWER SYSTEM
Notes to Combined Financial Statements, Continued

The Harry S. Truman project has a tentative cost allocation of \$155,637,527. Since being placed in service, this project's operations have been restricted because of limited water flow. The restrictions have prevented the project from producing power to its design capacity. A final determination of when, if ever, the project can reach full generating capacity has not yet been made. If the restriction on generating capacity is not removed, some change in allocation of cost may be required. If such a change in allocation is required, the cumulative effect will be determined and reflected as an adjustment to the financial statements at that time.

(4) Investment of U.S. Government

Construction and operation of the SWFPS transmission system and the Corps' generating plants and operations are financed through Congressional appropriations, except for the Robert Douglas Willis project which is financed by other parties. The U.S. Government investment in each generating project and each year's investment in the transmission system is to be repaid to the U.S. Treasury within the service lives of the assets, not to exceed 50 years from the time the facility is placed in service. There is no requirement for repayment of a specific amount on an annual basis. Annual revenues are first applied to the current year operating expenses (less depreciation) and interest expense. All annual amounts for such expenses have been paid through fiscal year 1994. Remaining revenues are to be first applied to repayment of operating deficits (which include all expenses except depreciation), if any, and then to repayment of the Federal investment. To the extent possible, while still complying with the repayment period established for each increment of investment and unless otherwise required by legislation, repayment of the investment is to be accomplished by repayment of the highest interest-bearing investment first. Interest rates applied to the unamortized initial investment of U.S. Government in the Corps' hydroelectric plants range from 2.5 percent to 3.125 percent for facilities in service at the beginning of the year and 7.125 percent for facilities placed in service during 1994. Interest rates applied to the unamortized investment of U.S. Government in Southwestern transmission facilities are approximately 2.5 percent for facilities in service at the beginning of the year and 7.125 percent for facilities placed in service during 1994. The rates have been set either by law, by administrative order pursuant to law, or by administrative policies using the U.S. Senate Document No. 97 formula for the fiscal year during which the appropriations were requested.

(5) Commitments and Contingencies

Based on the 1994 Integrated System Power Repayment Study, the projected increase in capital investment in 1995 is \$19,713,885 which includes \$5,843,900 for transmission facilities and \$13,869,985 for generating facilities. The five-year investment increase projected in the 1994 Power Repayment Study for 1995 through 1999 is estimated to cost \$95,742,534.

SWFPS is a party to certain claims and legal actions arising in the ordinary course of business. In addition, the Corps has begun studies for the purpose of determining whether possible environmental contamination exists at various dam locations. The cost of remediation, if any, at these sites is unknown. In management's opinion, these actions will not have a material adverse effect on the financial condition or results of operations of SWFPS.

SOUTHWESTERN FEDERAL POWER SYSTEM
Notes to Combined Financial Statements, Continued

(6) Restatement of Federal Investment

It was not determined how to properly recognize interest on Federal investment for power assets placed into service by the Corps districts within SWFPS between 1970 and 1988. Interior Department Order 2929 was issued in 1970 and generally requires the use of annual interest rates as set by the U.S. Treasury Department for new power projects. The Corps and the DOE agreed in 1983 to begin using the U.S. Treasury interest rate in the calculation of the interest on the Federal investment related to new power projects. The agreement also stipulated that the interest rates from 1970 to 1983 be analyzed to insure compliance with the agreement. No Corps district had implemented the U.S. Treasury interest rate provisions prior to fiscal year 1989.

The DOE and the Corps are currently researching the correct interest computation. As of December 16, 1994, no resolution of this matter has occurred. As such, no additional interest on Federal investment for the period 1970 to 1994 has been included in the accompanying financial statements. Resolution of this matter may require additional interest on Federal investment to be recognized.

SOUTHWESTERN FEDERAL POWER SYSTEM
Combining Statements of Assets, Federal Investment, and Liabilities
September 30, 1994

<u>Assets</u>	<u>Southwestern</u>	<u>Corps</u>	<u>Total</u>
Utility plant:			
Plant in service	\$ 120,109,786	917,623,213	1,037,732,999
Accumulated depreciation	(29,439,979)	(232,666,460)	(262,106,439)
Construction work in progress	25,154,902	8,737,178	33,892,080
Retirement work in progress	94,123	-	94,123
Net utility plant	<u>115,918,832</u>	<u>693,693,931</u>	<u>809,612,763</u>
Current assets:			
Unexpended appropriations	32,999,214	12,889,154	45,888,368
Accounts receivable	10,272,363	36,543	10,308,906
Materials and supplies, at average cost	<u>5,539,947</u>	<u>-</u>	<u>5,539,947</u>
	<u>48,811,524</u>	<u>12,925,697</u>	<u>61,737,221</u>
Banking exchange	16,144,112	-	16,144,112
Other assets	<u>10,493</u>	<u>972,321</u>	<u>982,814</u>
	<u>\$ 180,884,961</u>	<u>707,591,949</u>	<u>888,476,910</u>
<u>Federal Investment and Liabilities</u>			
Federal investment:			
Investment of U.S. Government:			
Congressional appropriations	\$ 568,068,452	1,356,119,309	1,924,187,761
Transfers from other federal agencies	14,574,521	12,149,214	26,723,735
Interest on Federal investment	34,528,451	585,365,817	619,894,268
Funds returned to U.S. Treasury	<u>(549,989,294)</u>	<u>(1,247,153,778)</u>	<u>(1,797,143,072)</u>
Net investment of U.S. Government	67,182,130	706,480,562	773,662,692
Accumulated net revenues (deficit)	<u>71,021,891</u>	<u>(3,239,543)</u>	<u>67,782,348</u>
Total Federal investment	138,204,021	703,241,019	841,445,040
Current liabilities - accounts payable and accrued liabilities	6,770,318	4,350,930	11,121,248
Purchase power and banking exchange deferral	35,608,965	-	35,608,965
Hydropower revenue deferral	<u>301,657</u>	<u>-</u>	<u>301,657</u>
Total Federal investment and liabilities	<u>\$ 180,884,961</u>	<u>707,591,949</u>	<u>888,476,910</u>

SOUTHWESTERN FEDERAL POWER SYSTEM

Combining Statements of Assets, Federal Investment, and Liabilities

September 30, 1993

<u>Assets</u>	<u>Southwestern</u>	<u>Corps</u>	<u>Total</u>
Utility plant:			
Plant in service	\$ 112,486,666	913,134,749	1,025,621,415
Accumulated depreciation	(26,858,571)	(223,680,627)	(250,539,198)
Construction work in progress	18,617,625	3,506,823	22,124,448
Retirement work in progress	104,431	-	104,431
	<u>104,350,151</u>	<u>692,960,945</u>	<u>797,311,096</u>
Net utility plant			
	<u>104,350,151</u>	<u>692,960,945</u>	<u>797,311,096</u>
Current assets:			
Unexpended appropriations	30,931,781	8,043,657	38,975,438
Accounts receivable	10,410,485	29,234	10,439,719
Materials and supplies, at average cost	3,925,819	-	3,925,819
	<u>45,268,085</u>	<u>8,072,891</u>	<u>53,340,976</u>
Banking exchange	15,579,585	-	15,579,585
Other assets	-	650,817	650,817
	<u>\$ 165,197,821</u>	<u>701,684,653</u>	<u>866,882,474</u>
 <u>Federal Investment and Liabilities</u>			
Federal investment:			
Investment of U.S. Government:			
Congressional appropriations	\$ 534,481,453	1,309,915,746	1,844,397,199
Transfers from other federal agencies	14,576,993	11,627,754	26,204,747
Interest on Federal investment	33,738,173	567,723,451	601,461,624
Funds returned to U. S. Treasury	(518,090,939)	(1,179,545,520)	(1,697,636,459)
Net investment of U.S. Government	64,705,680	709,721,431	774,427,111
Accumulated net revenues (deficit)	58,140,320	(10,995,584)	47,144,736
	<u>122,846,000</u>	<u>698,725,847</u>	<u>821,571,847</u>
Total Federal investment			
	<u>122,846,000</u>	<u>698,725,847</u>	<u>821,571,847</u>
Current liabilities - accounts payable and accrued liabilities	6,320,080	2,958,806	9,278,886
Purchase power and banking exchange deferral	35,747,376	-	35,747,376
Hydropower revenue deferral	284,365	-	284,365
	<u>41,351,821</u>	<u>2,958,806</u>	<u>44,310,627</u>
Total Federal investment and liabilities	<u>\$ 165,197,821</u>	<u>701,684,653</u>	<u>866,882,474</u>

SOUTHWESTERN FEDERAL POWER SYSTEM

Combining Statements of Revenues, Expenses, and Accumulated Net Revenues

Year ended September 30, 1994

	<u>Southwestern</u>	<u>Corps</u>	<u>Total</u>
Revenues:			
Sales of electric power:			
Cooperatives	\$ 66,795,409	-	66,795,409
Municipalities	27,054,771	-	27,054,771
Federal and state agencies	4,347,196	-	4,347,196
Investor owned utilities	1,300	-	1,300
Banking exchange	6,381,237	-	6,381,237
Transmission service charges for others	3,015,334	-	3,015,334
Other	86,054	220,459	306,513
Total revenues before deferrals	107,681,301	220,459	107,901,760
Net purchase power credit and banking exchange	1,501,755	-	1,501,755
Revenue distributed to Corps	(66,600,549)	66,600,549	-
Total revenues	42,582,507	66,821,008	109,403,515
Expenses:			
Operation and maintenance	15,870,616	31,786,960	47,657,576
Purchase power and banking exchange	7,751,565	-	7,751,565
Depreciation	2,932,757	9,701,757	12,634,514
Transmission service charges by others	2,645,019	-	2,645,019
Other	-	(19,909)	(19,909)
Total expenses excluding interest	29,199,957	41,468,808	70,668,765
Net revenues before interest expense	13,382,550	25,352,200	38,734,750
Interest expense on Federal investment	2,153,907	17,596,159	19,750,066
Allowance for funds used during construction	(1,652,928)	-	(1,652,928)
	500,979	17,596,159	18,097,138
Net revenues	12,881,571	7,756,041	20,637,612
Accumulated net revenues (deficits):			
Balance at beginning of year	58,140,320	(10,995,584)	47,144,736
Balance at end of year	\$ 71,021,891	(3,239,543)	67,782,348

SOUTHWESTERN FEDERAL POWER SYSTEM

Combining Statements of Revenues, Expenses, and Accumulated Net Revenues

Year ended September 30, 1993

	<u>Southwestern</u>	<u>Corps</u>	<u>Total</u>
Revenues:			
Sales of electric power:			
Cooperatives	\$ 70,873,303	-	70,873,303
Municipalities	25,736,676	-	25,736,676
Federal and state agencies	3,758,622	-	3,758,622
Investor owned utilities	49,166	-	49,166
Banking exchange	8,705,049	-	8,705,049
Transmission service charges for others	2,796,419	-	2,796,419
Other	85,680	200,648	286,328
Total revenues before deferrals	<u>112,004,915</u>	<u>200,648</u>	<u>112,205,563</u>
Net purchase power credit and banking exchange	3,542,538	-	3,542,538
Revenue distributed to Corps	<u>(81,347,399)</u>	<u>81,347,399</u>	<u>-</u>
Total revenues	<u>34,200,054</u>	<u>81,548,047</u>	<u>115,748,101</u>
Expenses:			
Operation and maintenance	16,179,765	27,151,235	43,331,000
Purchase power and banking exchange	6,474,934	-	6,474,934
Depreciation	2,775,920	8,096,425	10,872,345
Transmission service charges by others	2,690,554	-	2,690,554
Other	-	(36,218)	(36,218)
Total expenses excluding interest	<u>28,121,173</u>	<u>35,211,442</u>	<u>63,332,615</u>
Net revenues before interest expense	<u>6,078,881</u>	<u>46,336,605</u>	<u>52,415,486</u>
Interest expense on Federal investment	1,604,188	16,649,150	18,253,338
Allowance for funds used during construction	<u>(993,002)</u>	<u>-</u>	<u>(993,002)</u>
	<u>611,186</u>	<u>16,649,150</u>	<u>17,260,336</u>
Net revenues	5,467,695	29,687,455	35,155,150
Accumulated net revenues (deficits):			
Balance at beginning of year	<u>52,672,625</u>	<u>(40,683,039)</u>	<u>11,989,586</u>
Balance at end of year	\$ <u>58,140,320</u>	<u>(10,995,584)</u>	<u>47,144,736</u>

SOUTHWESTERN FEDERAL POWER SYSTEM

Combining Statements of Cash Flows

Year ended September 30, 1994

	<u>Southwestern</u>	<u>Corps</u>	<u>Total</u>
Cash provided by operating activities:			
Net revenues	\$ 12,881,571	7,756,041	20,637,612
Items not requiring cash:			
Revenue distributed to Corps	66,600,549	(66,600,549)	-
Interest expense on Federal investment	500,979	17,596,159	18,097,138
Depreciation	2,932,757	9,701,757	12,634,514
(Increase) decrease in:			
Accounts receivable	138,122	(7,309)	130,813
Materials and supplies	(1,614,128)	-	(1,614,128)
Banking exchange	(564,527)	-	(564,527)
Other assets	(10,493)	(321,504)	(331,997)
Increase (decrease) in:			
Accounts payable and accrued liabilities	450,238	1,392,124	1,842,362
Purchase power and banking exchange deferral	(138,411)	-	(138,411)
Hydropower revenue deferral	17,292	-	17,292
Cash provided by (used in) operating activities	<u>81,193,949</u>	<u>(30,483,281)</u>	<u>50,710,668</u>
Cash used in investing activities:			
Additions to utility plant	(12,850,982)	(9,913,283)	(22,764,265)
Allowance for funds used during construction	(1,652,928)	-	(1,652,928)
Cash used in investing activities	<u>(14,503,910)</u>	<u>(9,913,283)</u>	<u>(24,417,193)</u>
Cash provided by (used in) capital financing activities:			
Funds returned to U.S. Treasury	(98,498,904)	(1,007,709)	(99,506,613)
Congressional appropriations	33,586,999	46,203,563	79,790,562
Interest on Federal investment - purchase power deferral	289,299	46,207	335,506
Cash provided by (used in) capital financing activities	<u>(64,622,606)</u>	<u>45,242,061</u>	<u>(19,380,545)</u>
Net increase in cash	2,067,433	4,845,497	6,912,930
Cash at beginning of year	<u>30,931,781</u>	<u>8,043,657</u>	<u>38,975,438</u>
Cash at end of year	<u>\$ 32,999,214</u>	<u>12,889,154</u>	<u>45,888,368</u>
Noncash investing activities and other transactions -			
Transfer of plant in service (to) from other Federal agencies	<u>\$ (2,472)</u>	<u>521,460</u>	<u>518,988</u>

SOUTHWESTERN FEDERAL POWER SYSTEM

Combining Statements of Cash Flows

Year ended September 30, 1993

	<u>Southwestern</u>	<u>Corps</u>	<u>Total</u>
Cash provided by operating activities:			
Net revenues	\$ 5,467,695	29,687,455	35,155,150
Items not requiring cash:			
Revenue distributed to Corps	81,347,399	(81,347,399)	-
Interest expense on Federal investment	611,186	16,649,150	17,260,336
Depreciation	2,775,920	8,096,425	10,872,345
(Increase) decrease in:			
Accounts receivable	177,417	27,642	205,059
Materials and supplies	(13,127)	-	(13,127)
Banking exchange	(3,550,205)	-	(3,550,205)
Other assets	-	(209,442)	(209,442)
Increase (decrease) in:			
Accounts payable and accrued liabilities	1,019,530	(255,789)	763,741
Purchase power and banking exchange deferral	(1,811,377)	-	(1,811,377)
Hydropower revenue deferral	13,143	-	13,143
Cash provided by (used in) operating activities	<u>86,037,581</u>	<u>(27,351,958)</u>	<u>58,685,623</u>
Cash used in investing activities:			
Additions to utility plant	(13,935,439)	(3,417,201)	(17,352,640)
Allowance for funds used during construction	<u>(993,002)</u>	<u>-</u>	<u>(993,002)</u>
Cash used in investing activities	<u>(14,928,441)</u>	<u>(3,417,201)</u>	<u>(18,345,642)</u>
Cash provided by (used in) capital financing activities:			
Funds returned to U.S. Treasury	(100,623,733)	(808,117)	(101,431,850)
Congressional appropriations	21,907,000	31,811,887	53,718,887
Interest on Federal investment - purchase power deferral	<u>(738,935)</u>	<u>(13,058)</u>	<u>(751,993)</u>
Cash provided by (used in) capital financing activities	<u>(79,455,668)</u>	<u>30,990,712</u>	<u>(48,464,956)</u>
Net increase (decrease) in cash	(8,346,528)	221,553	(8,124,975)
Cash at beginning of year	<u>39,278,309</u>	<u>7,822,104</u>	<u>47,100,413</u>
Cash at end of year	<u>\$ 30,931,781</u>	<u>8,043,657</u>	<u>38,975,438</u>
Noncash investing activities and other transactions -			
Transfer of plant in service (to) from other Federal agencies	<u>\$ (28,534)</u>	<u>135,942</u>	<u>107,408</u>

700 Oklahoma Tower
Oklahoma City, OK 73102-5671

1600 One Williams Center
Tulsa, OK 74172-0168

INDEPENDENT AUDITOR'S REPORT ON THE INTERNAL CONTROL STRUCTURE

The Administrator of
Southwestern Power Administration
U.S. Department of Energy:

We have audited the combined financial statements of the Southwestern Federal Power System (SWFPS) as of and for the year ended September 30, 1994, and have issued our report thereon dated December 16, 1994. Our report includes an explanatory paragraph that describes the practice of allocating certain utility plant costs and operation and maintenance expenses relating to multi-purpose projects on a tentative basis between power and non-power purposes as discussed in Note 3 to the combined financial statements. Our report also includes an explanatory paragraph that describes an uncertainty related to the amount of interest on Federal investment that is required to be recognized as discussed in Note 6 to the combined financial statements.

We conducted our audit in accordance with generally accepted auditing standards, *Government Auditing Standards* (1988 Revision) issued by the Comptroller General of the United States and Office of Management and Budget (OMB) Bulletin 93-06, *Audit Requirements for Federal Financial Statements*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the combined financial statements are free of material misstatement.

In planning and performing our audit of the combined financial statements of SWFPS for the year ended September 30, 1994, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure.

The management of SWFPS is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that transactions, including those relating to obligations and costs, are executed in compliance with applicable laws and regulations that could have a direct and material effect on the combined financial statements and any other laws and regulations that OMB, management, or the Department of Energy have identified as being significant and for which compliance can be objectively measured and evaluated; funds, property and other assets are safeguarded against loss from unauthorized use or disposition; transactions are properly recorded and accounted for to permit the preparation of reliable financial reports in accordance with generally accepted accounting principles and to maintain accountability over the assets; and data that support reported performance measures are properly recorded and accounted for to permit preparation of reliable and complete performance information.

Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal control structure policies and procedures in the following categories:

- Revenues and receivables
- Purchases and payables
- Utility plant

For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk.

Our evaluation of the controls for performance information was limited to those controls designed to ensure the existence and completeness of the information. With respect to the performance measure control objective, we obtained an understanding of the relevant internal control structure policies and procedures designed to permit the preparation of reliable and complete performance information, and we assessed control risk.

DOE, through Southwestern, has responsibility for certain administration and financial reporting activities of the combined power system. Accordingly, comments and recommendations contained in this report will be communicated through Southwestern to the other participants in the combined power system.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants and OMB Bulletin 93-06. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the entity's ability to ensure that the objectives of the internal control structure, as previously defined, are being achieved.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe the reportable conditions described in Exhibit I are material weaknesses.

We considered the material weaknesses described in Exhibit I in forming our opinion on whether the SWFPS's 1994 combined financial statements are presented fairly, in all material respects, in accordance with the accounting policies described in the notes to the combined financial statements, and this report does not affect our report on those combined financial statements dated December 16, 1994.

This report is intended for the information of the management of SWFPS, Corps, and U.S. Department of Energy. However, this report, is a matter of public record and its distribution is not limited.

KPM & Peat Marwick LLP

Tulsa, Oklahoma
December 16, 1994

U.S. Army Corps of Engineers

1. Capitalizing Plant Assets

Generally accepted accounting principles and Corps regulations require an entity to capitalize and depreciate fixed assets at the time the asset is placed in service, except for certain cost below the capitalization threshold. Such costs are generally expensed as incurred.

The Corps' Little Rock and St. Louis districts recorded the costs of equipment and facilities that exceeded minimum limits for fixed assets as operations and maintenance expenses rather than capitalizing the costs as utility plant. Corps personnel could not readily determine why their accountants miscoded the costs; however the Corps does not have procedures for independently reviewing the coding accuracy of costs with amounts above the minimum limits. As a result, the financial statements, before adjustment, overstated operations and maintenance expenses by approximately \$510,000, and understated plant costs by the same amount.

Audit Recommendation

The Corps should consider establishing procedures for reviewing the propriety of the coding of all expenditures or contracts in excess of the minimum capitalization amount to enhance the proper coding of the transactions in the Corps' accounting system. Additionally, the following would also enhance the internal control structure:

- Cross-training of personnel
- Development of edit checks
- Monthly financial statements with timely review of such statements
- Monthly budgets that are separated between power and non-power projects

Corps Response

- a. Cross-training of personnel: concur

We firmly believe in cross-training but manpower reductions and hiring freezes have an impact on our ability to achieve a vital cross-training program.

- b. Development of edit checks: concur

We agree system edits should be present to prevent improper coding of accounting documents. However, major system changes are not practical since we are scheduled to implement a new financial management system during FY 95. Districts are developing manual edits to comply with the capitalization criteria.

- c. Monthly financial statements with timely review of such statements: non-concur

The manual effort associated with preparing monthly financial statements for hydropower projects makes this recommendation cost prohibitive.

- d. Monthly budgets that are separated between power and non-power projects: non-concur

We discussed this recommendation after the FY 92 and 93 audits and agreed with the concept. However, operating with our current budget and accounting systems would require an intense manual effort which makes it cost prohibitive.

2. Allocation of Joint-use Project Costs

Federal statute requires recovering the costs of power projects through power revenues. The costs allocable to power from a joint-use project of approximately \$3,285,000 were not properly included in the power reports and non-joint-use project costs of approximately \$3,265,000 were included in the power reports. Both of the projects related to the Beaver Dam, and the errors resulted from coding errors made when the projects were initially set up. Although the individual amounts were substantial, the errors offset one another and do not materially misstate cost in the fiscal year 1994 SWFPS combined financial statements.

Audit Recommendation

The Corps should establish procedures for periodically reviewing the classification of projects to ensure that all costs related to power are properly included and reported as power costs. At a minimum, the Corps should make the review at least annually before processing year-end transactions and preparing the power reports.

Corps Response

Concur

We have corrected the misclassification of the project in question. Districts have been reminded to review classification of significant projects.

3. Interest on Federal Investment

Department of Energy Order RA 6120.2 requires recovery of interest expense on the net outstanding Federal investment in power projects through power revenues. The Corps of Engineers presently computes interest expense for all projects in the Southwestern Federal Power System, and has included detailed guidance for the computation in Department of Army Circular EC 37-2-114. For additions and replacements, EC 37-2-114 requires using the current rate determined by the U. S. Treasury.

The Corps' Tulsa, Little Rock, and Vicksburg districts did not calculate interest on investment using the current U. S. Treasury interest rates. The property data in its Corps of Engineers Management Information System (COEMIS) did not contain sufficient detail to properly calculate interest using the current rates. Other Corps districts within SWFPS have used the current Treasury rate since fiscal year 1989. Corps officials agreed that COEMIS was designed to accept the property data required for using current interest rates; however, these three districts had not input the data into COEMIS in the proper manner.

We have not determined the impact of the understatement of interest on the Federal investment for fiscal year 1994 or for the accumulated interest on the Federal investment. Accordingly, the combined financial statements do not reflect the proper interest costs on the Federal investment.

Audit Recommendation

The Corps should require that the Tulsa, Little Rock and Vicksburg use the feature of COEMIS that would allow for proper calculation of the interest on Federal investment. The Corps should also require the Tulsa, Little Rock and Vicksburg districts to correctly determine the prior years interest on Federal investment related to power projects.

Corps Response

Concur

We will make an interest adjustment for FY 89 - 94. This fiscal year, districts will input current interest rates in the accounting system to comply with Engineering Circulars and Pamphlets.

General Corps Comments

Several of your recommendations are targeted at our accounting system. The Tulsa and Little Rock Districts are scheduled to implement a new financial system this fiscal year. The system will have sufficient edits and controls to accommodate your recommendations.

During FY 94, the Tulsa District lost several key people in the Civil Works Accounting Section and at the time of this audit, several of the positions had not been filled due to hiring freezes and/or manpower reductions. This has affected our ability to cross train, work with technical organizations, perform manual edits on accounting documents, and perform all other accounting program requirements. We will continue to work closely with SWPA to correct unresolved issues and to comply with audit findings.

KPMG Peat Marwick LLP

700 Oklahoma Tower
Oklahoma City, OK 73102-5671

1600 One Williams Center
Tulsa, OK 74172-0168

INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS

The Administrator of
Southwestern Power Administration
U. S. Department of Energy:

We have audited the combined financial statements of the Southwestern Federal Power System (SWFPS) as of and for the year ended September 30, 1994 and have issued our report thereon dated December 16, 1994. Our report includes an explanatory paragraph that describes the practice of allocating certain utility plant costs and operation and maintenance expenses relating to multipurpose projects on a tentative basis between power and non-power purposes as discussed in Note 3 to the combined financial statements. Our report also includes an explanatory paragraph that describes an uncertainty related to the amount of interest on Federal investment that is required to be recognized as discussed in Note 6 to the combined financial statements.

We conducted our audit in accordance with generally accepted auditing standards, *Government Auditing Standards* (1988 Revision) issued by the Comptroller General of the United States and Office of Management and Budget (OMB) Bulletin 93-06, *Audit Requirements for Federal Financial Statements*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws, regulations, and contracts applicable to SWFPS is the responsibility of SWFPS' management. As part of obtaining reasonable assurance about whether the combined financial statements are free of material misstatement, we performed tests of SWFPS' compliance with certain provisions of laws, regulations, and contracts that may directly affect the combined financial statements and certain other laws and regulations designated by OMB and the Southwestern Power Administration (Southwestern):

- Budget Accounting and Procedures Act
- Chief Financial Officer Act of 1990
- Prompt Payment Act
- Fair Labor Standards Act
- Federal Employee Compensation Act
- DOE Order RA 6120.2
- Buy America Act
- Flood Control Act of 1944
- Anti-Deficiency Act
- 18 Code of Federal Regulations (CFR) Part 300
- 10 CFR 903 - Power and Transmission Rates
- DOE Delegation Order No. 02304-108 - Approval of PMA Power and Transmission Rates
- DOE Order 2110.1A - Pricing of Departmental and Services
- U. S. Army Corps of Engineers' Directives ER 37-2-10 and SWDR 37-2-5

As a part of our audit, we also obtained an understanding of management's process at Southwestern only, for evaluating and reporting on internal control and accounting systems as required by the Federal Managers' Financial Integrity Act (FMFIA) and compared Southwestern's most recent FMFIA reports with the evaluation we conducted of Southwestern's internal control system. We also reviewed Southwestern's policies, procedures and systems for documenting and supporting financial, statistical, and other information presented in the Overview and Performance Measurement of the reporting entity and supplemental financial and management information. However, the objective of our audit of the combined financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

Material instances of noncompliance are failures to follow requirements or violations of prohibitions contained in statutes, regulations, or contracts that cause us to conclude that the aggregation of the misstatements resulting from those failures or violations is material to the financial statements, or the sensitivity of the matter would cause it to be perceived as sensitive by others. The results of our tests of compliance disclosed the following material instances of noncompliance:

Audit Comment

Errors in the recording of items between power and non-power purposes and between operations and maintenance expense and plant in service at the U. S. Army Corps of Engineers, as described in our report on internal controls, are also a violation of U. S. Army Corps of Engineers' Directive ER 37-2-10. See our report on internal controls dated December 16, 1994, for further discussion.

Audit Recommendation

The Corps should consider establishing procedures for reviewing the propriety of the coding of all expenditures or contracts in excess of the minimum capitalization amount to enhance the proper coding of the transactions in the Corps' accounting system. Additionally, the following would also enhance the internal control structure:

- Cross-training of personnel
- Development of edit checks
- Monthly financial statements with timely review of such statements
- Monthly budgets that are separated between power and non-power projects

The Corps should establish procedures for periodically reviewing the classification of projects to ensure that all costs related to power are properly included and reported as power costs. At a minimum, the Corps should make the review at least annually before processing year-end transactions and preparing the power reports.

Response

See response in Internal Control letter.

Audit Comment

Interest on Federal investment is not being calculated by the Corps in a manner consistent with an interagency agreement. The interagency agreement, dated September 1, 1983, required the use of current U. S. Treasury interest rates for 1984 and beyond. This was communicated to the Corps via circular (EC 37-2-114). The Corps' districts did not use the current U. S. Treasury rates, as discussed in EC 37-2-114, until fiscal year 1989 because the software to perform the calculations was not ready until then. Accordingly, the financial statements do not reflect the Corps' interest costs at rates established by the U. S. Treasury prior to 1989.

Audit Recommendation

We recommend that the Power Marketing Administrations resolve the issue of the start date for interest calculation as they have assumed the responsibilities of interest calculation and Federal repayment for upcoming years.

The Corps should require that the Tulsa, Little Rock and Vicksburg use the feature of COEMIS that would allow for proper calculation of the interest on Federal investment. The Corps should also require the Tulsa, Little Rock and Vicksburg districts to correctly determine the prior years interest on Federal investment related to power projects.

Response

See response in Internal Control letter.

Audit Comment

Federal statute requires power marketing agencies to establish power rates at levels sufficient to allow for repayment of the Federal investment, and to recover interest on the Federal investment and power project operating costs. Southwestern is not including the costs of certain post-employment benefits paid by the Office of Personnel Management in rates charged to utility users. Southwestern has not asked the Office of Personnel Management to provide Southwestern with the costs incurred for retirement, health, or disability insurance on former Southwestern employees or Corps employees associated with power operations. As a result, Southwestern is not fully recovering the costs of operating the power projects.

Audit Recommendation

Southwestern should work with the Office of Personnel Management to obtain the information necessary to include post-employment benefits in its rate structure.

Response

Southwestern has historically and consistently included civil service retirements benefits paid for current employees among the power costs which are recovered in our rate base.

It is the position of Southwestern management that the audit comment pertaining to post retirement benefits is erroneous, in that there is no statutory or regulatory mandate specifying that post retirement benefits paid by the Office of Personnel Management be recovered by Southwestern.

We considered the material instances of noncompliance in forming our opinion on whether SWFPS' 1994 combined financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report dated December 16, 1994, on those combined financial statements.

Except as described above, the results of our tests of compliance indicate that, with respect to the items tested, SWFPS complied, in all material respects, with the provisions referred to in the third paragraph of this report, and with respect to items not tested, nothing came to our attention that caused us to believe that SWFPS had not complied, in all material respects, with those provisions.

This report is intended for the information of the management of SWFPS, Corps, and U.S. Department of Energy. However, this is a matter of public record and its distribution is not limited.

K PMA Peat Marwick LLP

Tulsa, Oklahoma
December 16, 1994